

H. IRC 501(c)(3) - SUBSTANTIALLY BELOW COST

1. Introduction

Organizations that desire recognition of exemption under IRC 501(c)(3) must demonstrate that they are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. For an organization whose activities are directly and specifically in furtherance of one or more of the exempt purposes mentioned above, qualification for exemption can be relatively straightforward. For example, an organization that operates a church, a school, or a hospital can reasonably be said to be engaged in activities that are inherently religious, educational, or charitable. Similarly, an organization that provides food, clothing, and shelter to indigent individuals is relieving the poor and distressed, and clearly qualifies for exemption under IRC 501(c)(3) as a traditional charity. The direct accomplishment of specified exempt purposes through inherently exempt activities is the easiest way for most organizations to qualify for exemption under IRC 501(c)(3).

However, for a much smaller group of organizations whose activities are not inherently religious, charitable, or educational, the basis for recognition of exemption under IRC 501(c)(3) is not readily apparent. Such organizations may engage in activities that appear to be of a typical commercial nature, such as providing purchasing, investment, consulting, or insurance services. Because these services are provided only to organizations that are exempt under IRC 501(c)(3), organizations providing the service claim to qualify for exemption under IRC 501(c)(3).

The purpose of this topic is to discuss one of the circumstances in which such organizations can qualify for exemption under IRC 501(c)(3) where the services are provided at "substantially below cost."

A. Background - Feeder Provisions

In the Revenue Act of 1950, Congress addressed the problem created by the proliferation of businesses conducted by exempt organizations which had obtained unfair competitive advantage over taxable organizations engaged in similar business activities. To deal with these problems, Congress adopted a bifurcated

approach. First, in what is now IRC 502, Congress denied tax exemption to "feeder" organizations. Second, Congress sought, through IRC 511-514, to tax the "unrelated business income" of exempt organizations, that is, income generated by a trade or business the conduct of which is not substantially related to the exempt organization's purpose or function.

The 1983 CPE, pp. 83-105 contains an extensive discussion of feeder organizations. In summary, exemption is not allowed for an organization operated for the primary purpose of carrying on a trade or business for profit that claims exemption on the ground that all the profits are payable to one or more organizations exempt from tax under IRC 501.

Reg. 1.502-1(b) provides that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization its exemption will not be lost merely because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization. The regulation cites as an example a subsidiary organization operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

B. Background - Revenue Rulings

The Service applied the feeder provisions in Rev. Rul. 54-305, 1954-2 C.B. 127. The revenue ruling described an organization that was organized and operated for the primary purpose of operating and maintaining a purchasing agency for the benefit of its otherwise unrelated members who are exempt charitable organizations. The organization was formed to secure for hospitals and other

charitable institutions the advantages of cooperation in establishing uniform standards as to quality and kind of supplies and to purchase such supplies in accordance with definite specifications and agreements. Any hospital or similar institution was eligible for membership. Income was derived from dues, cash discounts or purchases for members, and service charges, all of which generated substantial profits. The revenue ruling cited the "feeder" provisions and concluded that the organization did not meet the requirements for exemption under IRC 101(6) (the predecessor of IRC 501(c)(3)). The ruling reasoned that the organization's activities consisted primarily of the purchase of supplies and the performance of other related services, and such activities in themselves cannot be termed charitable, but are ordinary business activities.

In addition to organizations providing group purchasing services, the Service also applied the feeder provisions to organizations providing investment services. Rev. Rul. 69-528, 1969-2 C.B. 127, concerned an organization formed to provide investment services on a fee basis exclusively to organizations exempt under IRC 501(c)(3). The organization received funds from the participating exempt organizations, invested in common stock, reinvested income and realized appreciation, and, upon request, liquidated a participant's interest with the proceeds being distributed to the participant. The participants did not control the organization and a participant's ownership interest did not entitle it to the whole or part of any property or the right to call for a partition, division, or accounting of the property. Again citing the feeder provisions, the Service held that the organization did not qualify for exemption under IRC 501(c)(3) or 501(c)(2) since it was regularly carrying on the business of providing investment services that would be unrelated trade or business if carried on by any of the tax-exempt organizations on whose behalf it operates. The revenue ruling notes that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

At the same time that Rev. Rul. 69-528 was published, another revenue ruling set forth a relatively new approach in the area of organizations providing commercial services to exempt organizations. Rev. Rul. 69-572, 1969-2 C.B. 119, describes an organization that was created to construct and maintain a building to house member agencies of a community chest. Membership in the organization was composed of the board of directors of the community chest, and all of the agencies occupying the building were exempt under IRC 501(c)(3). Construction expenses for the building were financed by contributions from the general public and by issuance of noninterest bearing obligations to other charitable organizations. The building was located on city land requiring only nominal rental

payment. The revenue ruling states that office space in the building was leased to member agencies at a rate that makes rental income equal total operating costs with no allowance for depreciation. The revenue ruling further states as a fact that the rental rate is substantially less than commercial rates for comparable facilities. Another given fact is that the building contains a large central meeting room for the free use of lessees and other interested community chest agencies.

Utilizing essentially a facts and circumstances approach, the revenue ruling concludes that the organization qualifies for exemption under IRC 501(c)(3). While the feeder provisions are not mentioned, it is noted that the performance of a particular activity that is not inherently charitable may nonetheless further a charitable purpose. The following factors appear to be the basis on which a favorable result was reached:

1. The organization's operations materially aid its various tenants in the performance of their charitable functions.
2. All tenants receive a direct financial benefit in that rental charges made are substantially less than the general commercial rate for comparable facilities.
3. Providing housing for a number of member agencies at one convenient central place enables the agencies to make frequent use of volunteer labor on an efficient basis.
4. There is a close connection between the organization and the charitable functions of the tenant organizations.
5. Rental rates are substantially below their fair rental value.
6. The organization's operations result in amounts only sufficient to meet annual operating costs.

Based on all these considerations, the organization's purposes and activities indicated that it was not acting merely in the capacity of a passive landlord. Rather, the organization provided the general public with a unique combination of services and facilities not otherwise available through ordinary commercial channels. Also significant was the fact that the organization's rental charges were far below normal commercial rates and thus below the amount that tenant organizations would otherwise have to pay in order to obtain necessary office space elsewhere,

thereby enabling the tenants to devote greater sums of money to their charitable activities.

Although Rev. Rul. 69-572 more than hinted at a "substantially below cost" principle, it would be two more years before the Service officially announced this position.

2. Two Important Revenue Rulings

A. Rev. Rul. 71-529 - Substantially Below Cost

In 1971, following extensive consideration, the Service published Rev. Rul. 71-529, 1971-2 C.B. 234. The revenue ruling describes an organization formed to aid organizations exempt under IRC 501(c)(3) by assisting them to manage more effectively their endowment or investment funds, including the making of arrangements for more effective handling of their funds, and by obtaining contributions to cover all or part of the costs of the management of such funds. Only colleges and universities exempt under IRC 501(c)(3) could become members in the organization whose board of directors consisted of representatives of the member organizations. These member organizations provided capital to the organization which placed these amounts in one or more common funds in the custody of various banks. The common funds were controlled and managed by the organization, which sought the advice of independent investment counsel in investing the funds. The organization's operating expenses were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee for the services performed. The revenue ruling states as a fact that these fees represent less than 15 percent of the total costs of operation.

The revenue ruling concludes that the organization qualifies for exemption under IRC 501(c)(3), and notes that the organization performs an essential function for charitable organizations, and that by performing this function for a charge that is substantially below cost the organization is performing a charitable activity.

By operating in the manner described, the organization was performing a function for charitable organizations by providing essential services, i.e., investment management, to organizations described in IRC 501(c)(3) at no cost to the organization or at a cost substantially below the ordinary cost of procuring such services. The favorable conclusion was thought to be not inconsistent with the holding in Rev. Rul. 69-528, because the organization in that ruling was primarily engaged in carrying on an investment management business for charitable

organizations on a fee basis free from control of the participants. Neither would IRC 502 preclude exemption, since the organization's services were only made available to the organizations controlling it, and since it made only a nominal charge for its services. Although not expressly stated, the conclusion of Rev. Rul. 71-529 is bolstered by the holding of Rev. Rul. 69-572, which effectively paved the way for the "substantially below cost" position.

A fair reading of Rev. Rul. 71-529 reveals the following key points:

1. Only organizations exempt under IRC 501(c)(3) could become members of the organization.
2. Member organizations controlled the organization.
3. Managing the endowment or investment funds of the member organizations is an essential function.
4. Most of the operating expenses were paid for by grants from independent charitable organizations.
5. Member organizations paid only a nominal fee for services performed.

B. Rev. Rul. 72-369 - The Donative Element

One year after the publication of Rev. Rul. 71-529, the Service found it necessary to refine somewhat the "substantially below cost" position. Rev. Rul. 72-369, 1972-2 C.B. 245, concerns an organization formed to provide managerial and consulting services for nonprofit organizations exempt under IRC 501(c)(3) to improve the administration of their charitable programs. The organization entered into agreements with unrelated nonprofit organizations to furnish managerial and consulting services on a cost basis (emphasis supplied). Among the services provided by the organization were writing job descriptions and training manuals, recruiting personnel, constructing organizational charts, and advising organizations on specific methods of operation. The organization's receipts were from services rendered, while disbursements were for operating expenses.

The revenue ruling holds that the organization does not qualify for exemption under IRC 501(c)(3) because its activities are not charitable. Providing managerial and consulting services on a regular basis for a fee is a trade or

business ordinarily carried on for profit. These activities are not transformed into charitable activities by being provided at cost and solely for exempt organizations. The revenue ruling contains the following significant statement:

"Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable."

The revenue ruling concludes by distinguishing Rev. Rul. 71-529 since the organizations receiving services in that ruling controlled the organization, and since the services were provided for a charge substantially less than cost.

In many ways, publication of Rev. Rul. 72-369 constitutes a reaffirmation of the longstanding Service position that an organization providing commercial services to exempt organizations does not itself qualify for exemption under IRC 501(c)(3). If this is viewed as a general rule, then the "substantially below cost" position expressed in Rev. Rul. 71-529 can be characterized as an exception to the general rule. By interjecting the concept of a "donative element" in Rev. Rul. 72-369, an important new idea was added to the discussion. Read together, both revenue rulings set forth conceptual boundaries whereby services provided at substantially below cost can be charitable, while services provided at cost are not charitable because of the absence of a donative element. With these new guidelines, the Service was in a better position to consider applications for exemption by organizations engaged in activities that are not inherently charitable.

C. The Lack of Subsidization

The absence of a donative element resulted in the organization described in Rev. Rul. 72-369 being denied exemption under IRC 501(c)(3). The presence of grants from independent charitable organizations enabled the organization described in Rev. Rul. 71-529 to provide its services at substantially below cost. The question arises as to the Service position if the organization described in Rev. Rul. 71-529 changed its method of operations from having its operating costs subsidized by grants or contributions from third parties to having such costs charged against the yield from the investment fund or funds operated by it.

The organization described in Rev. Rul. 71-529 was deemed to satisfy the operational test of IRC 501(c)(3) because of the fact that substantially all of the operating costs of the investment activities involved were to be subsidized by grants from independent charitable organizations. The reasoning appears to have been that because of this subsidization of the operating expenses the organization

would in effect be providing the investment and custodial services to the participating organizations virtually free of cost to them, or at least substantially below what it would cost to carry on such investment functions. Such subsidization was viewed as sufficient to qualify the organization's operations as charitable. It is apparent that the subsidization of the cost of the investment activities by the contributions from the charitable organizations was a determinative factor. If the subsidization feature were to be eliminated, one of the principal elements in the revenue ruling would be removed, and the Service would have to decide the basic issue: whether the establishment and operation of a mutual or common investment fund qualifies as a charitable activity under IRC 501(c)(3).

The organization's activities in operating a mutual investment fund or funds for the investment of funds of charitable organizations, if carried on without subsidization of the operating costs, are identical in all essential respects to the activities of an open-end investment trust or mutual fund. The operation of such a fund constitutes engaging in a trade or business for profit. This conclusion is not altered by the fact that participants in the fund are limited to organizations exempt under IRC 501(c)(3). Under the circumstances, the organization is essentially a mutual investment corporation organized and operated for the purpose of carrying on an ordinary form of commercial activity for profit and distributing the gains among its owners in proportion to their ownership in the venture. Thus, the organization is not a charity but a business. As such, its purpose is the conduct of business and the maximization of gains and profits therefrom for the financial benefit of the investing charities, not as beneficiaries of a charity or charitable trust, but as owners and investors in the organization. Distributions are made pursuant to strictly contractual obligations rather than any charitable obligation or trust imposed on the corpus of the investment fund, and this is characteristic of a business rather than a charity.

There is no doubt that the conduct of the mutual investment activities constitutes the regular carrying on of trade or business that is not substantially related to the exercise or performance of any charitable function aside from the need or the use to which the income is put by the investing organization. Without the benefit of subsidization, the only basis for a claim that the organization is operated for charitable purposes would be that all of the income from its investment activities is payable to organizations exempt under IRC 501(c)(3). Since the income in question derives from activities that constitute the carrying on of trade or business, and since the carrying on of such activities is the organization's primary purpose, the feeder provision of IRC 502 would preclude exemption under IRC 501(c)(3). In addition, exemption under IRC 501(c)(2) as a

title holding company would not be available, among other reasons, because the only trade or business that such an organization may engage in is the rental of real property, and because, in accordance with Rev. Rul. 69-528, the feeder provision would also be applicable. There is no doubt that without the subsidization feature the organization described in Rev. Rul. 71-529 would not qualify for exemption under IRC 501(c)(3). The only other alternative would be for the organization to obtain legislative relief.

3. IRC 501(f) - Cooperative Service Organizations of Operating Educational Organizations

In 1974, Congress amended the Internal Revenue Code to provide exemption under IRC 501(c)(3) for organizations that are similar to the organization described in Rev. Rul. 71-529 without the above mentioned subsidization feature. Before discussing IRC 501(f), it should be noted that a somewhat similar provision was enacted as IRC 501(e) covering cooperative hospital service organizations. IRC 501(e) is beyond the scope of this topic, but it has been the subject of previous CPE Texts, most recently in 1982.

IRC 501(f) provides that an organization will be treated as being organized and operated exclusively for charitable purposes if it meets the following requirements:

- (1) The organization must be organized and operated solely to hold and invest monies contributed by member organizations,
- (2) Monies contributed must be invested in stocks and securities,
- (3) The organization must collect income from the contributed amounts and turn over the entire amount, less expenses, to the member organizations,
- (4) The organization must be organized and controlled by one or more member organizations,
- (5) Members of the organization must be organizations described in either IRC 170(b)(1)(A)(ii) (educational organizations) or IRC 170(b)(1)(A)(iv) (organizations benefitting state and municipal colleges and universities),
- (6) Members of the organization must be either exempt under IRC 501(a), or their income must be excluded from taxation under IRC 115.

IRC 501(f) is effective for taxable years ending after December 31, 1973. A careful reading of the statute indicates that Congress created a narrowly-drawn exception to the Service position that a mutual investment fund for charitable organizations does not qualify for exemption under IRC 501(c)(3) where services are not provided at substantially below cost. Of particular importance is the fact that not all 501(c)(3) organizations are appropriate members of a 501(f) organization. The statute specifically provides that only educational organizations described in IRC 170(b)(1)(A)(ii) and organizations benefiting state and municipal colleges and universities described in IRC 170(b)(1)(A)(iv) may be members of a 501(f) organization. These members must organize and control the organization. There is no need to demonstrate that services are provided at substantially below cost, nor must a donative element be present. Because of this statutory amendment, the absence of subsidization would not be a bar to classification as a charitable organization if the organizational, operational, and membership requirements of IRC 501(f) are met.

The existence of such a narrowly-drawn statutory exception supports a conclusion that organizations which fail to meet the restrictive requirements of IRC 501(f) would not qualify for exemption under IRC 501(c)(3).

4. Cost/Below Cost

Following publication of Rev. Ruls. 71-529 and 72-369, the Service gave extensive consideration to the question of whether exemption under IRC 501(c)(3) might be precluded where an organization charges for goods or services that it provides in connection with its activities that would otherwise be considered to be in furtherance of charitable purposes. The general issue was described as the "Cost/Below Cost" issue. As noted previously, the presence of costs of services provided was a material consideration in both Rev. Rul. 71-529, where services were provided at substantially below cost, and in Rev. Rul. 72-369 where services were provided at cost.

The following five hypothetical examples should be considered:

Organization A took orders for food cooperatives and food buying clubs. A food buying club is a loosely structured group of persons who jointly order food for members and divide among them the labor of procuring and delivering the food and accounting for operating expenses. A's prices were significantly below those

charged by commercial retail groceries. Leftover food was given free of charge to those who could not afford to buy it.

Organization B was organized to assist residents in a low-income, economically depressed urban area in obtaining better housing. The area served by B contains numerous abandoned apartment buildings and many other buildings in extremely deteriorated condition that are likely to be abandoned in the future. State law permits tenant groups to petition a civil court to appoint an administrator to collect the rents from such buildings and to apply these rents to the repair of dangerous and unhealthy conditions in the buildings. Such administrators are appointed by the court and are legally responsible for maintaining and repairing the building. The administrator collects rents and is empowered to hire maintenance and repair persons. B's principal activity was to serve as the agent of the court-appointed administrators, who would turn over rents from the buildings to B to use for maintenance and repair of the buildings. The expenditure of rents by B for the renovation and repair of apartment buildings was subject to the control and approval of the building's tenants, the court-appointed administrator, and the court itself. In addition to the actual renovation of the buildings, B also trained tenants through meetings and discussion groups in various aspects of building maintenance and management. By statute the administrator received five percent of the rents collected in buildings being managed. No private concerns were willing to undertake such management activity for a five percent fee. B initially declined to accept fees, but subsequently did accept the fees in order to supplement its operating funds. The fees are substantially less than would normally be required to furnish the services in question, and B is dependent upon contributions and volunteer assistance.

Organization C was formed to improve the quality of philanthropy by providing staff assistance and management consultant services to organizations exempt under IRC 501(c)(3). C maintains a staff of qualified personnel to counsel administrators of tax-exempt organizations in establishing and operating charitable programs for maximum effectiveness. Existing charitable programs are evaluated and improvements are recommended. C is not controlled by or related to any of the tax-exempt organizations requesting and receiving its assistance. It charges fees which are substantially less than the cost of services rendered. Its principal source of funds is from foundation grants and contributions from the general public. Disbursements are made for salaries and other operating expenses.

Organization D was formed by the boards of trustees of various educational organizations to act as the administrative office of educational organizations. D has

responsibility for ordering supplies and equipment for the educational institutions and prepares payroll records for employees, processes personnel appointments, and handles administrative tasks. D also engages in fund raising and personnel recruitment for the member institutions. Similar services were also provided for some non-member organizations all of which were exempt under IRC 501(c)(3). A de minimis amount was also expended for a non-exempt literary society. D's receipts consists of contributions, interest, and members' advances and assessments. Members pay monthly advances, and, if necessary, a year-end assessment to cover any deficit. Such year-end assessments are apportioned on the basis of time utilized in performing services. Amounts charged for services were structured to enable D to cover the deficit resulting from operating expenses exceeding its donation and grant income. Fees were not specific and uniform as to services rendered, but were computed on the basis of each organization's proportional share of the operating costs, based on the amount of services rendered to each organization. D's receipts from contributions were less than its receipts from member fees.

Organization E was created to provide a vehicle for developing joint cooperative projects among school systems in a particular state. E engages in research, conducts studies, and provides management consulting, operational and coordinational services to school districts and educational organizations. E offers at cost to subscribing schools and school districts its services and facilities for the cooperative purchasing of materials, food and food services, transportation, data processing, financial management, and building maintenance and operation. E states that the total operation is run below cost if the fair value of the contributed services of non-salaried officers is considered as well as the service contributions of its members. Funds are obtained from charitable foundations, trusts, private individuals, as well as fees paid for services performed.

As a general rule, the fact that an organization claiming exemption under IRC 501(c)(3) charges for goods or services will be relevant in very few cases. When the activities of an organization are uniquely suited to the accomplishment of its charitable purposes, the only inquiry should be whether the charges made in connection with the activities significantly detract from the organization's charitable purposes. When the community clearly benefits from an organization's activities, a reasonable charge will usually not negate the benefit; the only exceptions appear to be when the charge works to deprive a major part of the community of access to the organization and its program, or when the organization derives a profit from its activities beyond that necessary to the conduct of its exempt function.

The "cost/below cost" issue is relevant only in comparatively few cases in which the activities of an organization are not uniquely suited to the accomplishment of a charitable purpose but are of a commercial nature. Organizations engaging in such activities may claim that charitable classification is warranted because they charge a reduced fee for the goods or services that they provide. As a general rule, activities of an ordinary commercial nature are not appropriate means of accomplishing charitable purposes, and a mere reduction in the fee charged in connection with the activities will not warrant charitable classification under IRC 501(c)(3). There are two exceptions to this rule. First, when an organization provides necessary goods or services to the poor at substantially below cost, it may be relieving the poor and distressed. Second, when an organization provides goods or services to other IRC 501(c)(3) organizations at substantially below cost, it may, in effect, be similar to a grant-making charity assisting the recipient organizations to carry out their charitable programs.

Applying this discussion of the "cost/below cost" issue to the above mentioned five organizations, it appears that some of the organizations would qualify for exemption under IRC 501(c)(3), while others would not. Organization A would not qualify for exemption because its services are not limited to the poor. If A served only the poor, however, the question would be whether its charges for food were inconsistent with charitable status. Giving food to the poor is an acceptable way of relieving poverty, while selling food to the poor at the regular market price would be doing no more than a commercial business. Selling food at anything less than market price would somewhat relieve the poverty of the purchasers, and selling food at a nominal amount would be even more effective. When the only distinguishing factor is that something less than market price is charged, that price should be low enough to ensure that the organization's purpose of relieving poverty is served. In the absence of other factors supporting exemption an organization relieving poverty through the sale of commercially available goods or services should be recognized as exempt only if the sales are at prices substantially below its cost of operation. Such other factors in support of exemption might be, for example, an educational program on nutrition for low-income consumers.

Organization B would qualify for exemption under IRC 501(c)(3) since its activities are distinguishable from those of an ordinary commercial nature. The receipt of fees in connection with the building management program is only part of a larger program to service the low-income residents of the buildings. The management program itself is not of a commercial nature since no commercial

concerns were willing to provide the services at a five percent fee. This type of management operation is apparently not economically feasible for commercial concerns. B's overall program is reasonably calculated to relieve the poverty of the individuals being served, and its acceptance of the five percent fee is not inconsistent with its goal of relieving poverty.

Although organization C is not controlled by the exempt organizations receiving its services, it could still qualify for exemption under IRC 501(c)(3) since its services are provided at substantially below cost. Although the absence of control by the recipient organization distinguishes B from the organization described in Rev. Rul. 71-529, this fact alone is not sufficient to negate exemption under IRC 501(c)(3). The presence of contributions from the general public and from foundations enables B to operate at substantially below cost.

The conclusion with respect to organization D is less certain because of the absence of clear and convincing evidence that D's operations are at substantially below cost. Although D appears to be providing services at somewhat below cost, the requisite substantiality of such amount seems to be lacking. Similarly, organization E is offering its services at cost, and under Rev. Rul. 72-369, exemption under IRC 501(c)(3) would not be recognized. However, if E were to generate substantial receipts from contributing foundations and individuals, it might be able to show that its joint purchasing services are provided at substantially below cost. Further, if its activities were limited to providing services to school districts that are part of the state or local government, it might qualify for exemption under IRC 501(c)(3) based on lessening the burdens of government.

5. B.S.W. Group, Inc. v. Commissioner

In 1978 the Tax Court considered a declaratory judgment petition filed by an organization seeking recognition of exemption under IRC 501(c)(3) based on its providing consulting services for a fee to nonprofit organizations. In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court held that the organization did not qualify for exemption under IRC 501(c)(3).

A. The Organization

B.S.W. Group, Inc. was incorporated in Delaware and has its principal place of business in Maryland. B.S.W. was formed for the purpose of providing consulting services primarily in the area of health, housing, vocational skills, and cooperative management. B.S.W. intended to help such organizations to deal with

problems by implementing realistic internal planning and management policies, and to improve their understanding of governmental policy processes and methods for becoming more effective in their work through public and private funding. B.S.W. would serve its client organizations by furnishing consultants to perform basic and applied research, including such areas as vocational skills training, alternative housing, health and health delivery systems, alternative financing for small-scale entrepreneurs, environmental impact programs, solid waste disposal, and multiple uses of organic and inorganic compounds in farm production activities. The services provided would be an alternative to full-time staffing of client organizations where budget considerations and lack of expertise would otherwise prevent such staffing.

All of B.S.W.'s consulting clients were to be tax-exempt organizations and not-for-profit organizations (some of which may not be tax-exempt). Individuals serving as independent contractors under contract with B.S.W. would perform the actual consulting services. These individuals would be compensated by B.S.W., which would charge the client organizations a fee for making the arrangements with individual consultants. B.S.W. would negotiate the fee, which to some extent would be based on the client's ability to pay, as well as the value of the services to the client. Although the consulting services would be provided at or close to cost, fees would be sufficiently high to enable B.S.W. to retain at least a "nominal" administrative fee over and above the amount payable to individual consultants. A proposed budget revealed income of \$18,000, expenses of \$16,050, with net income of \$1,950. Income would be derived solely from consulting services.

B. The Service Position

B.S.W. Group, Inc. was denied exemption under IRC 501(c)(3) because it did not meet the "operational test" of Reg. 1.501(c)(3)-1(c), since it was primarily engaged in an activity which is characteristic of a trade or business. The adverse ruling relied in part on Rev. Rul. 72-369, which holds, as discussed earlier, that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under IRC 501(c)(3). On this basis, a final adverse ruling was issued and B.S.W. invoked the declaratory judgment procedure of IRC 7428.

C. The Tax Court Decision

The Court agreed with the Service's adverse ruling, noting that B.S.W.'s activity constitutes the conduct of a consulting business of the sort which is

ordinarily carried on by commercial ventures organized for profit. B.S.W. failed to demonstrate that its own services or those performed by its consultants are not in competition with commercial businesses such as personnel agencies, consulting referral services, real estate agents, housing rental services, banks, loan companies, trash disposal firms, or environmental consulting companies. The Court stated that competition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes.

The opinion states that B.S.W.'s only role is that of a conduit linking individual researchers with interested client organizations seeking a substitute for full-time staffing, and this is not inherently charitable, scientific, or educational. Nor does the organization's financing resemble that of a typical 501(c)(3) organization. Voluntary contributions have neither been solicited nor received from the public. B.S.W.'s only source of income is fees for services, which are set high enough to recoup all projected costs and which produce a substantial net profit in the amount of 10.8 percent of income. Significantly, B.S.W. does not appear to charge a fee less than "cost" and although this fee is nominal and may be lower than those charged by other firms, the Court did not believe that this was sufficient to bring the organization within the scope of IRC 501(c)(3).

Another negative factor was B.S.W.'s failure to limit its clientele to organizations which are themselves exempt under IRC 501(c)(3). Rather than providing services exclusively to 501(c)(3) organizations, B.S.W. also provides services to organizations that are "tax-exempt" or "not-for-profit." The category "tax-exempt" encompasses organizations that are exempt under a subsection of IRC 501(c) other than IRC 501(c)(3), while the category "not-for-profit" encompasses a variety of organizations including taxable entities. B.S.W.'s failure to limit its services to 501(c)(3) organizations further detracts from its claim for exemption under IRC 501(c)(3).

The Court concludes by stating the following:

" . . . we are unable to find that petitioner's primary purpose is educational, scientific or charitable, rather than the conduct of an ordinary commercial consulting enterprise in competition with other commercial firms."

6. Application of Principles

Consider the following hypotheticals:

A. Charitable Risk Pooling

Organization L was created pursuant to a state statute allowing organizations exempt under IRC 501(c)(3) to establish, and become beneficiaries of, a trust fund for the purpose of providing protection against the risk of financial loss due to damage, destruction, or loss to property, or the imposition of legal liability. Such provisions were enacted in response to the difficulty experienced by religious and charitable organizations in securing property and public liability coverage at reasonable prices. L asserts that in many situations affordable coverage is unavailable from commercial sources. L's purpose is to establish benefit programs to protect and indemnify the beneficiaries against risks of loss due to damage, destruction or loss of their property, or the imposition of legal liability, except any liability imposed by workmen's compensation, occupational disease, or employer's liability law. L's beneficiaries are limited to organizations that are exempt under IRC 501(c)(3), and include a church, school, music conservatory, YMCA, United Way, and various other charitable, religious, and educational organizations. L provides property, general liability, and automobile coverage through pooled self-insurance, collective negotiated excess or reinsurance coverage, administrative services, loss prevention services, and claim services.

Premiums charged to beneficiary organizations are based on L's operating costs. Financial support is received from contributions of member organizations, investment earnings and an application fee. L anticipates receiving contributions from individuals and organizations independent of their participation in the risk-pooling program, so that the amounts charged beneficiary organizations would be reduced. However, only one relatively small annual contribution in the form of cash and services has been received. L represents that it provides coverage for its member organizations at an aggregate price (i.e., cost to beneficiaries) that is almost 50 percent below the price paid for similar services in the commercial marketplace. Such low price is attributable to the voluntary services of its trustees and the absence of agent commission fees upon the sale of plans of coverage. On the basis of L's operating at almost 50 percent below the price of commercial insurance, it is argued that L may be considered to be operating at substantially below the cost of commercial insurance obtainable by beneficiaries on the open market. Although L has not demonstrated that it provides its services at a price substantially below the cost of its own operations, the argument is advanced that the actual "cost" is the cost to the beneficiaries for L's services rather than the cost to L in providing its services.

The Service position is that L does not qualify for exemption under IRC 501(c)(3). L's only effect on the charitable organizations it services is the reduction of the amount expended for insurance coverage. The benefits of risk-pooling represent a very minimal amount of the budgets of the participating exempt organizations. Because L serves a large and potentially unlimited class of charitable organizations serving a variety of exempt purposes, it is not associated with any distinct charitable purpose. Providing lower insurance costs alone does not satisfy the organizational and operational tests of IRC 501(c)(3), where a charitable purpose is lacking. If this were not so, every cooperative venture which seeks to provide goods and services at discounted prices solely to charitable organizations could demand exemption on the grounds that the exempt purposes of the charitable organizations were being promoted.

With regard to the argument that L's operations are at substantially below cost, the price charged must be sufficiently below cost that the activities are clearly distinguishable from those of its commercial counterparts by manifestation of a donative intent. The "cost" relevant to the analysis is the cost to the organization seeking exemption in providing the goods and services, and not the cost to recipients in obtaining similar goods and services on the open market. Contributions received by L from sources other than the participating beneficiary organizations are relatively insubstantial. Although L provides insurance coverage at almost 50 percent below commercial market prices, this information is not directly relevant to the "substantially below cost" issue. Whether the price charged to beneficiaries translates into a substantial percentage below L's own cost is pertinent.

B. Group Purchasing for Exempt Organizations

Organization M was formed on behalf of participating charitable organizations as a central purchasing, ordering, buying, and payment facility. M was created by a parent exempt organization which serves as its only member. Over 100 beneficiary societies of the parent participate in the group purchasing service, together with almost 400 other charitable organizations. M receives from each vendor a small percentage (averaging 1.2 percent) of the net invoice price of all goods and services purchased by a participating institution under each contract. M is housed in the parent organization's building and the parent supplies M office services. M has a small staff of professionals, its board of directors serves without compensation, and its advisory committees are unpaid by M. These committees consist of either employees of participating organizations or outside experts. Its accountants and legal counsel charge it reduced "charity" rates.

If M is to qualify for recognition of exemption under IRC 501(c)(3), it would have to show that it is operated at substantially below cost. Initially M represented that its services were provided during a three year period at 36, 16, and 25 percent below cost, respectively. In arriving at these figures M included the value of services contributed to it, the fair market value of space furnished by M's parent, and services contributed by client agencies. The Service position is that the fair market value of in-kind contributions, like cash contributions, should be taken into account in determining an organization's cost. There is no valid distinction between cash and in-kind contributions where the donors are disinterested third parties. But where contributions are received from an organization's parent, customers, or other closely related entities, a different situation exists. Since the parent organization owns M, controls all its activities, and has complete control over the distribution or use of its earnings or profits, none of the parent's in-kind contributions to M, its subsidiary, should be considered in determining M's "cost." Nor should any in-kind contributions from the participating institutions be considered. Although they do not own or control M, they possess the real beneficial interest in and are the direct beneficiaries of M's lower costs. Such contributions are merely additional payments for goods and services received. Of course the unreimbursed out-of-pocket costs of the parent may be utilized in determining whether M's operations are substantially below cost.

If this analysis is applied to M for the three year period, rather than operating at 36, 16, and 25 percent below cost, M operated at between 10 and 12 percent below cost. Although there is no uniform numerical standard used in determining whether the substantially below cost test is met, the charge must be sufficiently limited so that the activities are clearly distinguishable from those of a commercial nature. Something significantly in excess of 15 percent below cost is necessary, and charges that range between 10 and 15 percent below cost are not "substantially below cost." Under these circumstances M would not qualify for exemption under IRC 501(c)(3).

Another issue is whether M's promotion of vendor sales serves the private interests of vendors more than incidentally. The thinking is that M provides a valuable service for which vendors are willing to pay a commission on each sales invoiced amount at a rate sufficient to cover most of M's operating costs. In the absence of the master contracts arranged by M, the participating charitable organizations would purchase a given product from a number of vendors, as opposed to purchasing from the one vendor with the master contract. The master contracts benefit both the charities through reduced prices and the vendors through

increased volume of business and profits. The theory is that the "substantially below cost" issue need not be reached in a situation where commercial vendors are benefited more than incidentally through an organization's arranging of master contracts between charities and vendors.

7. Summary

The "substantially below cost" concept can best be described as an exception to the general rule that organizations providing commercial services to exempt organizations do not qualify for exemption under IRC 501(c)(3). The absence of inherently charitable activities may result in an organization having to demonstrate that its ostensibly commercial services are provided at substantially below cost. The two revenue rulings discussed previously, 71-529 and 72-369, still constitute valid precedent and should be considered initially upon receipt of a case involving the substantially below cost issue. Although relatively few organizations attempt to qualify for exemption on this basis, those that do often generate difficult technical questions, especially with respect to calculating percentages indicative of operating substantially below cost. Particular attention should be paid in order not to confuse the organization's cost with the cost in the marketplace, and also with respect to in-kind contributions from parent organizations and participating charitable organizations. Because of financial pressure to maximize available funds and to economize in general, it is possible that more applications for exemption will be received from organizations providing commercial services to organizations exempt under IRC 501(c)(3).